

Tax Supported
New Issue

State of Vermont

Rating

General Obligation Bonds AA+

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New Issue Details

\$26,000,000 General Obligation Refunding Bonds, 2005 Series B, are scheduled for competitive bids on Feb. 16. Bonds will be due March 1, 2006–2025 and are callable on or after March 1, 2015 at par.

Security: The bonds are general obligations of the State of Vermont, with its full faith and credit pledged.

■ Outlook

Vermont's conservative approach to debt and financial operations provides a strong foundation for its high credit quality. During the protracted recession period of the early 1990s, the state assiduously followed an austere recovery program, demonstrating well its willingness to take appropriate action for stability. Following recovery, its reserves were fully funded, expenditure levels remained under control, and substantial surplus was used for capital purposes, allowing debt to decline. The state's economy weakened in 2001–2002, and revenues were below projections. Appropriations were cut, but partial use of the reserve was still necessary. Operations subsequently have been favorable, and reserves are fully re-built.

■ Rating Considerations

Important to Vermont's long-term credit assessment is the demonstrated willingness to keep debt within manageable parameters and fidelity to the simplicity of debt structure, having used faith and credit obligations almost exclusively. Virtually all direct debt remains general obligation. Debt has declined for six consecutive years, debt ratios are moderate, and amortization is rapid. In line with affordability recommendations, annual borrowing has been reduced, and considerable capital needs have been met from cash, not bonding.

Financial operations were successful for the six years through 2001. After elimination of the deficit in fiscal 1996, the rebuilding of the budget stabilization reserve commenced followed by the setting up of further reserves for education and welfare as well as the use of current surplus for capital purposes. Reserves became fully funded at 5% of revenues. Revenues, driven by the personal income tax, consistently exceeded estimates until weakness surfaced in 2001. During fiscal 2002, tax revenues dropped, and despite expenditure measures, over half of the reserve was tapped. In fiscal 2003, revenues recovered to meet estimates, and in fiscal 2004, with help from the federal stimulus package, a \$57 million general fund surplus was recorded, allowing for full replenishment of reserves. Fiscal 2005 revenues to date are ahead of estimates, and last month, the state raised estimates for both fiscal years 2005 and 2006.

Vermont lost about 5% of employment in the early 1990s recession, but by 1994, employment had exceeded the pre-recession level. However, manufacturing employment, higher paying than the services sector, was slower to recover. While good gains were made, jobs in the sector remained below the 1980s' level. Manufacturing again suffered from 2000–2003, falling 19% before stabilizing this year. This loss was offset by resiliency in other sectors, and total employment was virtually unchanged from 2000–2003 before resuming growth during 2004.

February 9, 2005

■ Strengths

- Virtually exclusive use of general obligations.
- Moderate and declining debt ratios, with affordability planning.
- Generally conservative policies.
- Reserves built during strong financial periods.
- Deficit plan followed in adverse situation.

■ Risks

- Some vulnerability through manufacturing importance.
- Rapidly growing Medicaid and education expenditures constrain future budgets.

■ Debt Position

Vermont has a favorable debt position with no constitutional or statutory restrictions. All direct debt is now general obligation, as a minor amount of leases and certificates of participation (COPs) was refunded in 1998. The bonds, which refunded the leases and COPs, are treated as special fund bonds for internal cost accounting purposes but are actually general purpose obligations. General purpose bonds are serviced from the general fund and highway debt from the transportation fund. Not included in the debt is that issued by the Education and Health Building Finance Agency for the benefit of developmental and mental health services providers, although much support for the programs is from state appropriations.

There is considerable exposure through credit extension, although it was significantly reduced with the sale of the portfolio of the Vermont Home Mortgage Board, which had liabilities of \$117 million in 1998. The state's full faith and credit back up certain programs of the Vermont Economic Development Authority (VEDA), including the authority to insure up to \$15 million in mortgages, and the authority is authorized to reimburse lenders participating in the Financial Access Program to a maximum of \$2 million. Mortgages amounted to \$10.6 million, and the reimbursement liability was about \$1 million. VEDA has issued commercial paper (\$46.4 million outstanding) for financing new loans; the commercial paper program has a reserve deficiency makeup provision with the state, not to exceed \$55 million. Calls on the various guaranties have been minor. There are reserve fund deficiency makeup provisions with the Municipal Bond Bank and the Housing Finance Agency, with the latter limited to \$125 million in bonds; no calls have been made through this provision.

Debt Statistics

(\$000)

General Obligation Bonds:	
General Purpose: Outstanding	430,333
To be Issued*	41,000
Transportation Bonds	14,349
Total General Obligation Debt	485,682

Contingent Liabilities:	
Economic Development Authority	958

Reserve Fund Commitments:	
Bond Bank	446,455
Housing Finance Agency	92,160
Economic Development Authority	55,000

Gross Tax-Supported Debt	1,080,255
Less: Contingent Liabilities	958
Reserve Fund Commitments	593,615
Net Tax-Supported Debt	485,682

Debt Ratios

Net Tax-Supported Debt	
Per Capita (\$)**	798
As % of Personal Income	2.5
As % of Estimated Property Value	0.9

*Includes this issue and \$15 million in bonds expected in March 2005.

**Based on 2000 census.

Short-term debt has been employed regularly, both for operating and capital purposes. In 1993–1997, it was entirely in the form of commercial paper. Operations in fiscal 1998 were so favorable that operating debt was reduced to \$20 million, down from \$105 million in 1997, and the period of need was brief. There was then no need for operating borrowing until fiscal 2003 when \$75 million was issued. In fiscal 2004, \$48 million was issued, and no short-term borrowing is planned for fiscal 2005.

Vermont has a capital debt affordability advisory committee that will recommend prudent debt authorizations, taking into account, among other things, debt in relation to personal income and debt service in relation to revenues. A range of \$75 million–\$100 million annually over the 1990s was set, but amounts were lowered reflecting the recession. Annual amounts declined from \$64 million in fiscal 1994 to \$43 million in 1997 and 1998 and to under \$40 million in each year from 1999–2004. The recommendation rose to \$41 million in fiscal 2005 and \$45 million in 2006. Authorizations have approximately matched recommendations, although surpluses were used to reduce bonding in fiscal years 2000 and 2001.

The state will follow this issue of refunding bonds with \$15 million of general obligation Vermont

citizen bonds shortly. The state now makes annual bond authorizations, eliminating any overhang of authorized but unissued debt.

Debt ratios are well within the moderate range. Ratios had been rising, but the smaller annual issuance has now become evident. In addition, surplus has been directed to capital purposes, reducing borrowing. From 1992–1997, tax supported debt rose 29%, but excluding the deficit notes outstanding in 1992, the increase was 50% while personal income rose 26% over the period. Debt currently is about 16% below the 1997 level, while personal income rose 36% from 1997–2003.

■ Financial Operations

The general fund is the basic operating account. Accounting has been done on a cash basis, but the conversion to generally accepted accounting principles (GAAP) was completed for the 1996 fiscal year. Vermont's comprehensive annual financial report for fiscal 2002 was delayed until November 2003 due to complications of a new financial system and conversion to GAAP Statement 34. The 2003 report was delayed until December 2004 as a result of the overhang of the previous year's problems and a delay in auditing capital assets. The state believes it has taken steps to remedy the problems and expects the fiscal 2004 audit to be issued this spring.

After a difficult period, Vermont returned to surplus operations in fiscal 1996, which, when combined with a transfer from the transportation fund, eliminated the general fund deficit from the previous year. During fiscal 1997, revenues were well over estimates and a major reserve fund deposit was made. At June 30, 1997, the budget stabilization fund had a balance of \$35.1 million, \$7 million was in reserve for education and \$2.9 million was reserved for debt reduction. The transportation fund held \$7 million in its reserve.

Financial operations in the following years were favorable, with revenues generally ahead of estimates, operating surpluses achieved, and reserves fully funded to 5% of revenues. Additionally, significant appropriations were made for capital and other one-time purposes. In fiscal 2001, growth slowed, but an operating surplus of \$36 million was achieved. Cigarette taxes, which totaled \$11 million in the previous year, began to flow to the health care access trust fund instead of the general fund. Reserves at year-end included \$43 million in the stabilization reserve, \$18 million in the human

General and Special Revenue Funds

(\$000, GAAP)

	2000–2001	2001–2002	2002–2003
Revenues	2,634,600	2,804,565	2,913,367
Taxes	1,590,021	1,600,725	1,615,244
Federal Aid	849,190	964,141	1,036,188
Expenditures	2,567,207	2,894,940	3,055,008
Education	884,781	1,035,570	1,090,652
Human Services	910,389	1,065,880	1,202,966
Transportation	294,277	311,133	284,978
Debt Service	73,895	69,214	73,213
Operating Result	3,229	(17,840)	(88,109)
General Fund Balance	172,757	149,594	99,752
Undesignated Balance	86,583	97,898	47,061

GAAP – Generally accepted accounting principles.

services caseload reserve, and \$31 million was reserved for other purposes, for a total of \$92.6 million. The transportation fund had a small operating surplus of \$6 million; at June 30, its stabilization reserve held \$8.9 million

The fiscal 2002 budget assumed that available revenue would be around the same level as in the previous year, and the operating surplus after transfers of \$23 million to the transportation and education funds was set at \$9.3 million. In fact, general fund revenues were about 7% lower than in 2001 and 10% below original estimates. The personal income tax was 11% below the previous year and 13% below original estimates, primarily due to the capital gains, options, etc. component. Revenue estimates were lowered twice during the year, and in response, appropriations were reduced; however, the final shortfall dictated the use of \$29 million from the reserve, leaving \$17 million in that fund.

The budget for fiscal 2003 was premised on revenues of \$883 million, but estimates were lowered in July; the gap was to be met from transfers and cuts. However, revenues actually matched the original level, and in essence, the transfers were added to reserves. Taxes for the year rose 3.1%, reflecting strength in insurance and estate taxes, while the personal income tax was up only 0.9% and the sales tax, 1.8%. At the close of the year, the general fund stabilization reserve was about one-half funded at \$23.5 million and the transportation reserve held \$9.2 million. A caseload reserve amounted to \$17.2 million. The education fund drew on its reserve, bringing it down to \$11.2 million.

The fiscal 2004 budget expected moderate revenue growth. Actual growth was 4.5% for the income tax and 17.0% for the sales tax (inclusive of a rate increase). The state also received \$50 million in one-time federal aid plus \$32.9 million in enhanced Medicaid support, which allowed it to bolster various reserve accounts and make

one-time expenditures. The state closed fiscal 2004 with a \$57 million general fund surplus, which was reduced by year-end transfers to the transportation fund, teacher's retirement, the caseload reserve, and other funds. The state also transferred \$20.9 million to fully fund the stabilization reserve and carried forward a \$15.6 million surplus. The state also realized surpluses in both the transportation and education funds, which allowed full funding of the reserves for those accounts, and a \$14.9 million surplus was carried forward in the education fund.

Fiscal 2005 revenue estimates, originally set at \$922.6 million in January 2004, were raised to \$950 million in July and \$981.3 million last month. Through December, revenues are up 6.8%, with personal income tax up 4.4% and sales tax up 5.6% ahead of July estimates. The governor has proposed appropriating \$32.9 million of the expected surplus for supplementary fiscal 2005 appropriations, mostly in human services, and \$36.7 million to reserves and pre-paying fiscal 2006 expenses.

The governor has proposed a \$1.003 billion general fund budget for fiscal 2006. He proposed reducing projected Medicaid deficits by increasing participant contributions, redirecting the property transfer tax (approximately \$10 million in annual receipts) from the general fund to the health access trust fund, and negotiating for more flexibility from the federal government.

Education fund spending is up sharply this year as the result of Act 68, which increased the state's share of K-12 education spending and lowered local property taxes. The sales tax was raised from 5% to 6% on Oct. 1, 2003, and effective July 1, 2004, one-third of all sales tax receipts are allocated to the education fund, with the remainder retained in the general fund. The act also splits the statewide property tax rate, with homestead property taxed at a rate equal to about two-thirds of the nonresidential rate, which takes advantage of the significant number of out-of-state second home owners in Vermont.

The transportation and education funds are important in state operations. Transportation revenues have been favorable — though fuel and motor vehicle purchase taxes are sluggish this year — and its reserve is fully funded. The education fund relies on the allocation of the sales tax, the statewide property tax, lottery proceeds, and motor vehicle purchase and use tax receipts. Operations of the fund have often relied on use of its reserve, which is now also fully funded.

Vermont's pension systems are strong. The State Employees Retirement System was 97.4% funded at the last actuarial valuation on June 30, 2004. The Vermont State Teacher's Retirement System was 90.2% funded. The state has funded the teacher's system below the actuarially recommended contribution; however, it added a portion of the fiscal 2004 surplus and plans to do so again in fiscal 2006, and the governor's fiscal 2005 budget increases the contribution. The governor also proposed to begin a trust fund to pre-fund the future liability of retiree health benefits.

■ Economic Base

Vermont's economy includes manufacturing, tourism, and agriculture, although the latter has declined considerably in importance while services have expanded. Health and education services now account for nearly 18% of employment, and leisure and hospitality make up nearly 11%, both well above the national average. Educational services alone are 4.2% of Vermont's jobs, nearly twice the national share.

Manufacturing, mostly durables, is still important at 12% of jobs. Manufacturing declined in the 1990s recession, with employment dropping from over 50,000 in 1985 to the 43,000 level in the early 1990s. There was recovery, with 2000 manufacturing employment at 46,400 but slipping by 2003 to 37,600 and stabilizing this year at near that level. The state's largest private employer continues to be IBM, which reduced its work force, primarily in the Burlington area, by some 1,800 employees during the recession, although it recently added back some 250 employees. General Electric also has a significant manufacturing facility in Rutland. Tourism is broad based, including several ski areas for winter attraction, while the scenic beauty and countryside encourage summer visitors. Several ski areas have undergone improvement, including a continuation of year-round use. The widespread second home and condominium usage already provides some stability. Canadian tourism and shopping are an economic factor.

Employment in Vermont peaked in 1989 after a period of rapid growth. About 5% of employment was lost, only about half as severe as the losses in most New England states. By the end of 1994, the loss had been regained, and 2000 employment was about 14% over the earlier peak. Employment gained 1.0% in 2001 before falling 1.0% in 2002 and holding flat in 2003. Vermont began gaining jobs this past year, with December 2004 employment up 1.0%, compared with the same month a year ago. Increases included 2.5% in

Employment Trends

Employment (000)

	VT	% Change	U.S.	% Change
1985	225	—	97,387	—
1989	262	16.4	108,014	10.8
1990	258	(1.5)	109,487	1.4
1991	249	(3.5)	108,374	(1.0)
1992	251	0.8	108,726	0.3
1993	257	2.4	110,844	1.9
1994	264	2.7	114,291	3.1
1995	270	2.3	117,298	2.6
1996	275	1.9	119,708	2.1
1997	279	1.5	122,776	2.6
1998	285	2.2	125,930	2.6
1999	292	2.5	128,993	2.4
2000	299	2.4	131,785	2.2
2001	302	1.0	131,826	0.0
2002	299	(0.7)	130,341	(1.1)
2003	299	0.0	129,931	(0.3)
December 2003	305	—	130,035	—
December 2004p	308	1.0	132,226	1.7

Unemployment Rate (%)

	VT	U.S.	VT as % of U.S.
1985	4.8	7.2	67
1989	3.6	5.3	68
1990	5.0	5.6	90
1991	6.4	6.8	94
1992	6.7	7.5	89
1993	5.5	6.9	80
1994	4.7	6.1	77
1995	4.2	5.6	75
1996	4.6	5.4	85
1997	4.0	4.9	82
1998	3.4	4.5	76
1999	3.0	4.2	71
2000	2.9	4.0	73
2001	3.6	4.7	77
2002	3.7	5.8	64
2003	4.6	6.0	77
December 2003	4.7	5.7	82
December 2004p	3.4	5.4	63

Personal Income (Change from Prior Year)

	% Change		VT as % of U.S. Growth
	VT	U.S.	
1991	1.3	3.5	37
1992	6.8	6.3	108
1993	3.1	3.7	83
1994	4.9	5.2	95
1995	4.8	5.3	89
1996	5.4	6.0	90
1997	6.9	6.1	114
1998	6.1	7.4	83
1999	5.8	5.1	114
2000	7.9	8.0	98
2001	5.4	3.5	153
2002	2.6	1.7	150
2003	3.6	3.2	114

Per Capita Income (Change from Prior Year)

	% Change		VT as % of U.S. Growth
	VT	U.S.	
1991	0.6	2.1	29
1992	6.0	4.8	124
1993	2.2	2.4	93
1994	3.8	3.9	98
1995	3.8	4.1	94
1996	4.6	4.8	96
1997	4.7	4.8	99
1998	7.1	6.1	116
1999	5.1	3.9	129
2000	7.0	6.8	102
2001	4.9	2.5	198
2002	2.0	0.7	284
2003	3.1	2.2	146

Components of Personal Income: Earnings

	VT		% Change	U.S.		% Change
	2001	2003	2001–2003	2001	2003	2001–2003
Manufacturing	19	17	(7)	14	14	2
Durable Goods Manufacturing	15	13	(8)	9	9	1
Trade	17	17	9	17	16	4
Education and Health Services	14	15	17	10	11	15
Professional and Business Services	9	9	6	15	15	2
Financial Activities	6	7	14	10	10	7
Construction	7	7	9	6	6	5
Government and Government Enterprises	16	17	13	16	16	11

State Population: 608,827 (2000)

Population Change 1990–2000: VT 8.2%; U.S. 13.2%

Personal Income Per Capita 2002: \$30,534 = 97% of U.S.; rank 22nd.

leisure, 2.5% in professional services, 2.3% in health and education services, 0.8% in trade, and 0.4% in government. Construction and information were flat, and manufacturing was down 0.3%. Unemployment is consistently among the lowest in the nation.

Through most of the 1990s, personal income growth in the state lagged the national experience. However, in the past few years, Vermont gains have exceeded those of the U.S., both in total and on a per capita basis. In third-quarter 2004, state personal income rose 6.0% over last year, compared with 5.4% in New England and 5.2%

nationally. In 2003, Vermont's per capita personal income was equal to 97% of the U.S. figure, ranking it 22nd, up from 28th in 2000 and 32nd in 1993.

Vermont's population grew 8.2% during the 1990s, faster than the New England region, yet slower than the U.S. The census bureau estimates Vermont has

grown about 0.5% per year this decade, about as fast as New England but slower than the U.S. Vermont's population is well-educated, with nearly one-third of adult Vermonters holding college degrees, ranking ninth of the 50 states. Vermont also has the nation's largest share of population — nearly three-quarters — living outside the state's primary metropolitan area.

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